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SUPREME COURT RULES THAT TRADEMARK LICENSEE RETAINS LICENSE RIGHTS FOLLOWING REJECTION IN BANKRUPTCY

To Our Clients and Friends:

On May 20, 2019, the Supreme Court held in *Mission Product Holdings, Inc. v. Tempnology, LLC*, __ S. Ct. __, 2019 WL 2166392 (May 20, 2019) that a chapter 11 debtor-licensor's rejection of a trademark license agreement under section 365(a) of the Bankruptcy Code does not terminate the license granted in the agreement. Most lower courts that have addressed this issue found that a licensor's rejection of a trademark license agreement in bankruptcy terminated the license, noting that the protections afforded by Bankruptcy Code section 365(n) to licenses of certain types of intellectual property do not apply to trademark licenses.

As a result of this decision, licensees of trademarks (including licensees of a bundle of different types of intellectual property that include trademarks) could be expected to conclude that they no longer need to implement special measures to protect against termination of such license in bankruptcy.[1]

I. Background of Rejection and Trademark Licenses

Section 365(a) of the Bankruptcy Code allows a debtor (or trustee) to assume or reject an executory contract or unexpired lease.[2] Pursuant to section 365(g), "the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease."[3] As a result of rejection, the debtor is relieved from future performance obligations under the agreement, and the contract counterparty is entitled to a general unsecured claim for the damages resulting from the debtor's nonperformance.[4]

In a seminal decision in 1985, the Fourth Circuit held in *Lubrizol* that a licensor-debtor's rejection of a patent license under section 365(a) of the Bankruptcy Code had the additional impact of revoking the licensee's patent license.[5] *Lubrizol* was the first appellate decision to declare that rejection of a license agreement under section 365(a) terminates a licensee's license. As a result of the *Lubrizol* decision, "Congress sprang into action," enacting section 365(n) to "ensure the continuation of patent (and some other intellectual property) licensees' rights."[6]

Notably, section 365(n) does not apply to trademark licenses;[7] therefore, most courts addressing the issue had determined that a licensee's trademark license did not survive a debtor's rejection of a trademark license agreement.[8]

II. Procedural History in *Mission Product Holdings*

In *Mission Product Holdings*, Tempnology, LLC (the "Debtor") had entered into a license agreement with Mission Product Holdings, Inc. ("Mission") in which it granted Mission the exclusive license to distribute trademarked products in the United States along with a non-exclusive license to use the trademarks worldwide.[9] The Debtor subsequently filed bankruptcy and sought and received authority to reject the agreement pursuant to section 365(a) of the Bankruptcy Code.[10]

Following rejection of the license agreement, the parties agreed that the Debtor was relieved from any future performance under the agreement and that Mission could file a general unsecured claim against the Debtor for damages resulting from the Debtor's nonperformance.[11] However, the Debtor also sought a declaration by the bankruptcy court that rejection terminated Mission's right to use the Debtor's trademarks.[12]

The bankruptcy court agreed that rejection terminated Mission's trademark license, reasoning that a negative inference should be drawn from Congress's failure to protect trademark rights in section 365(n), and distinguishing trademark rights from the treatment of other intellectual property rights under section 365(n).[13] The First Circuit affirmed the bankruptcy court's decision, declining to follow the Seventh Circuit's decision in *Sunbeam*, which held that rejection by a debtor does not terminate the licensee's trademark license.[14]

III. Supreme Court's Analysis

The Supreme Court's analysis in *Mission Product Holdings* largely rests on the plain language of the Bankruptcy Code. Specifically, section 365(g) provides that rejection constitutes a "breach," and, therefore, "[r]ejection of a contract—any contract—in bankruptcy operates not as a rescission but as a breach."[15] The Court adopted the *Sunbeam* interpretation of section 365(g) and rejected the "negative inference" that some courts had extrapolated from section 365(n) with respect to trademark protection, emphasizing the "general bankruptcy rule" that a debtor's estate "possess anything more than the debtor itself did outside bankruptcy."[16]

Accordingly, the Court reversed the First Circuit's decision and held that the Debtor's rejection of the license agreement did not revoke Mission's trademark license.[17]

IV. Implications of Decision

Courts in future cases involving licenses of intellectual property that is governed by section 365(n) (e.g., licenses of patents, copyrights or trade secrets) will need to consider the extent to which, if at all, the *Mission Product Holdings* decision affects the treatment of such licenses under section 365.[18] Based on the plain language of section 365(n), which expressly applies to rejection of certain intellectual property licenses, and the Court's decision recognizing section 365(n) as "embellishing on or tweaking the general rejection-as-breach rule," it seems likely that courts will hold that section 365(n) continues to govern the extent to which a licensee of intellectual property other than trademarks can preserve its license rights following rejection of the underlying license.[19]

The *Mission Product Holdings* decision may result in disparate treatment for trademark licenses as compared to other types of intellectual property. Justice Sotomayor provides an example of such disparate treatment in her concurring opinion: section 365(n) provides that a "licensee that chooses to retain its rights postrejection must make all of its royalty payments; the licensee has no right to deduct damages from its payments even if it otherwise could have done so under nonbankruptcy law."[20] Because a trademark licensee is not required to comply with section 365(n), she notes that "the Court's holding confirms that trademark licensees' postrejection rights and remedies are more expansive in some respects than those possessed by licensees of other types of intellectual property."[21] It should be noted, however, that a licensee that continues to exercise its trademark license rights following rejection will be subject to applicable state law requirements, which may include a continuing obligation to pay royalties or license fees to the licensor in a manner consistent with the requirements of section 365(n)(2)(B).

On the other hand, a court may determine that a trademark licensee's rights are more limited in some respects. For example, section 365(n) specifically provides that a covered licensee may elect to retain its rights to "enforce any exclusivity provision" of a rejected license agreement.[22] In the context of a trademark license, it is not clear whether a debtor could breach an exclusive trademark license agreement and begin licensing to third parties or whether a licensee is nevertheless entitled to equivalent protections based on nonbankruptcy law and the Supreme Court's reasoning in *Mission Product Holdings*. It might also be possible, without the protections of section 365(n), for a licensee to forfeit its trademark rights following rejection by a debtor based on the terms of the license and "applicable nonbankruptcy law."[23]

Given the different treatment afforded to trademark licenses, if a licensor of bundled intellectual property rights that include both rights governed by section 365(n) and trademark rights, even though the trademark rights are automatically preserved following rejection under *Mission Product Holdings* decision, those subsisting trademark rights likely will not be exercisable by the licensee in a meaningful fashion unless the other licensed intellectual property rights are retained through the licensee making an election under section 365(n), which requires the licensee to continue to pay the debtor-licensor any licensee fees owing under the agreement without setting off any damage claims it may have.

The extent of the difference in treatment of rejected trademark licenses as compared to rejection of other types of intellectual property licenses is certain to be explored in future cases.

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[1] Measures adopted by prospective licensees include requiring the licensor to grant a security interest in valuable collateral to secure the licensor's obligation to license the trademark or to arrange for the licensor to set up a bankruptcy-remote subsidiary to hold and license the trademark.

[2] 11 U.S.C. § 365(a); *Mission Product Holdings, Inc. v. Tempnology, LLC*, __ S. Ct. __, 2019 WL 2166392, at *2 (May 20, 2019) ("A contract is executory if performance remains due to some extent on both sides.") (citation omitted).

[3] 11 U.S.C. § 365(g).

[4] *Mission Product Holdings*, 2019 WL 2166392, at *2; 11 U.S.C. § 502(g)(1).

[5] *Lubrizol Enterprises v. Richmond Metal Finishers*, 756 F.2d 1043, 1045-1048 (4th Cir. 1985). Prior to the Fourth Circuit's *Lubrizol* decision in 1985, a number of courts did not follow the rule adopted in *Lubrizol*. *See*, *e.g.*, *Fenix Cattle Co. v Silver (In re Select-A-Seat Corp.)*, 625 F2d 290, 293 (9th Cir 1980) (observing that trustee's rejection of software license did not affect licensee's rights to continue to use and sell licensed computer software, and stating that a license "cannot be summarily terminated, but rejection can cancel covenants requiring future performances by the debtor").

[6] *Mission Product Holdings*, 2019 WL 2166392, at *7.

[7] The legislative history of section 365(n) indicates that Congress concluded that trademark licenses raised special considerations because of a licensor's affirmative obligation to monitor a licensee's use of licensed trademarks and enforce quality control standards, and Congress intended bankruptcy courts to consider application of the principles of section 365(n) to trademark licenses on an equitable basis. Senate Rep. No. 100–505, 100th Cong., 2d Sess. at 6 (1988), reprinted in 1988 U.S.C.C.A.N. 3200, states that "since these matters [relating to trademark licensing] could not be addressed without more study, it was determined to postpone Congressional action in this area and to allow the development of equitable treatment of the situation by bankruptcy courts."

[8] *Mission Product Holdings*, 2019 WL 2166392, at *7. A notable exception is *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012), where the Seventh Circuit held that a licensor's rejection of a trademark license did not result in termination of the trademark license. Given the inequity of a trademark licensee losing its rights through rejection, some courts extended protection to licensees by finding the subject trademark licenses not to be executory contracts that are subject to rejection under section 365(a) of the Bankruptcy Code. *See*, *e.g*., *In re Exide Techs.*, 607 F.3d 957, 964-65 (3d Cir 2010) (exclusive, perpetual, fully paid trademark license deemed to be substantially performed and therefore not executory, notwithstanding the licensee's indemnity, further assurances, and quality control obligations that remained unperformed).

[9] *Mission Product Holdings*, 2019 WL 2166392, at *2.

[10] *Id.*

[11] *Id.* at *3.

[12] *Id.*

[13] *Id.* at *3-4.

[14] *Mission Product Holdings, Inc., v. Tempnology, LLC (In re Tempnology, LLC)*, 879 F.3d 389, 404 (1st Cir. 2018) (citing *Sunbeam Prods.*, 686 F.3d 372).

[15] *Mission Product Holdings*, 2019 WL 2166392, at *5.

[16] *Id.* at *6.

[17] *Id.* at *9. Notably, the decision does not address the consequences of rejection of a license by a debtor-licensee and should not affect the treatment of intellectual property licenses that are rejected by a debtor-licensee.

[18] A licensee in such a case could argue that, because the *Mission Product Holdings* decision holds that a rejection does not rescind license rights, its license rights are automatically retained without it needing to satisfy the conditions for retention of a rejected license that are set forth section 365(n).

[19] *Id.* at *7 n.2.

[20] *Id.* at *9 (Sotomayor, J., concurring) (citing 11 U.S.C. § 365(n)(2)(C)(i)).

[21] *Id.* (Sotomayor, J., concurring).

[22] 11 U.S.C. § 365(n)(1)(B).

[23] *Mission Product Holdings*, 2019 WL 2166392, at *9 (Sotomayor, J., concurring).

Gibson, Dunn & Crutcher's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Business Restructuring and Reorganization, Intellectual Property, Technology Transactions or Media, Entertainment and Technology practice groups, or any of the following:

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